MORNING BRIEFING
March 21, 2017

What Is Normal?

See the collection of the individual charts linked below.

(1) Old timers. (2) The DJIA is up 20-fold since my first day on the Street. (3) Lots of adages. (4) Let the trend be your friend. Don't fight the Fed. Taking away the punch bowl. Three strikes. (5) Bull markets start when Fed starts to ease, and continue when it starts to tighten. (6) Fed's tightening usually ends badly. (7) If the real neutral federal funds rate is zero, the nominal rate should equal the inflation rate (2% currently). (8) Yellen's swan song: Leave on a neutral note.

Strategy I: Secular Bull. There are lots of old timers in the stock market. In a few more years, I could be one of them. I'm not sure how much time qualifies one to be an old timer. I've been watching and writing about the stock market since the late 1970s. I haven't aspired to be a market timer so much as to be an investment strategist, getting the trends right rather than calling every turn. Fortunately for me, my career so far has spanned an amazing secular bull market.

When I started on Wall Street at EF Hutton during January 1978, the Dow Jones Industrials Average was around 1000 (*Fig. 1*). It had been trading around this level since 1971. On October 11, 1982, it finally rose above that level, and hasn't revisited it again since. By November 21, 1995, it had increased five-fold to 5000, and then ten-fold to 10,000 by May 29, 1999. By January 25, 2017, it had increased 20-fold to 20,000 since I started on Wall Street.

Of course, along the way, there were a few wicked bear markets (defined as 20.0% or greater declines in the S&P 500) and plenty of nasty corrections (defined as 10.0%-19.9% declines) (*Fig. 2*). On balance, I was mostly bullish most of the time. I remained bullish during almost all the corrections. I wasn't sufficiently bearish when the tech and housing bubbles burst. However, I correctly saw the selloffs as buying opportunities. Since January 1978, the S&P 500 has risen during 30 years and declined during nine years (*Fig. 3*). So the odds clearly favored the bulls, as did the total returns.

All of the above confirms the age-old adage often recited by old timers: "Let the trend be your friend." The trend has been bullish because the economy has mostly expanded from 1978 through 2016. Over this period, there were 139 up quarters for real GDP, and 17 down quarters (*Fig. 4*). S&P 500 forward earnings, which starts in 1979, has been tracking an annual trend growth rate of 6%-7% (*Fig. 5*). Over the same period, the S&P 500 index price has been tracking at an 8%-9% pace of appreciation, with lots of volatility attributable to fluctuations in the P/E (*Fig. 6*).

Strategy II: The Fed & the S&P 500. There are plenty of other adages that are more short-term-oriented and focus on the Fed's impact on the stock market. They tend to be more cautionary and are recited by old timers who've lived through some wicked bear markets and fearsome corrections. The basic message is that the Fed is your friend until it isn't. Consider the following:

(1) *Zweig*. Martin Zweig was a highly respected analyst and investor who passed away in 2013. He famously often said "Don't fight the Fed." He started his newsletter in 1971 and his hedge fund in 1984. On Friday, October 16, 1987, in a memorable appearance on *Wall Street Week with Louis Rukeyser*, he warned of an imminent stock market crash. It happened the following Monday, and Zweig became

an investment rock star. His newsletter, *The Zweig Forecast*, had a stellar track record, according to Mark Hulbert, who tracks such things.

In his 1986 book *Winning on Wall Street*, Zweig elaborated on his famous saying: "Monetary conditions exert an enormous influence on stock prices. Indeed, the monetary climate—primarily the trend in interest rates and Federal Reserve policy—is the dominant factor in determining the stock market's major direction. … Generally, a rising trend in rates is bearish for stocks; a falling trend is bullish." There are two reasons for this, he wrote: "First, falling interest rates reduce the competition on stocks from other investments, especially short-term instruments such as Treasury bills, certificates of deposit, or money market funds. … Second, when interest rates fall, it costs corporations less to borrow. … As expenses fall, profits rise. … So, as interest rates drop, investors tend to bid prices higher, partly on the expectation of better earnings. The opposite effect occurs when interest rates rise."

(2) *Martin.* In 1949, President Harry Truman appointed Scott Paper CEO Thomas McCabe to run the Fed. McCabe pushed to regain the Fed's power over monetary policy and did so with the Fed-Treasury Accord of 1951. He negotiated the deal with Assistant Treasury Secretary William McChesney Martin. McCabe returned to Scott Paper and Martin took over as chairman of a re-empowered Federal Reserve on April 2, 1951, serving in that position until January 31, 1970 under five presidents. The March 1951 Accord freed the Fed and marked the start of the modern Federal Reserve System. Under Martin, the Fed's overriding goals became price and macroeconomic stability. He believed that the Fed's job was to be a party pooper. His famous "punch bowl" metaphor seems to trace back to a speech given on October 19, 1955 in which he said:

"In the field of monetary and credit policy, precautionary action to prevent inflationary excesses is bound to have some onerous effects—if it did not it would be ineffective and futile. Those who have the task of making such policy don't expect you to applaud. The Federal Reserve, as one writer put it, after the recent increase in the discount rate, is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up."

(3) *Gould.* According to the Market Technicians Association, the late technical analysis pioneer Edson Gould, who was active from the 1930s through the 1970s, observed that "whenever the Federal Reserve raises either the federal funds target rate, margin requirements, or reserve requirements three times without a decline, the stock market is likely to suffer a substantial, perhaps serious, setback." This adage is widely known as "three steps and a stumble." So far, investors are betting against it since stocks actually rose sharply last Wednesday after the Fed hiked the federal funds rate for the third time since the Great Recession.

What do the data show about the relationship between the Fed's monetary policy cycle and the S&P 500? Monthly data for the index show that it tends to bottom during the beginning of easing phases of monetary policy, when the Fed is lowering the federal funds rate (*Fig. 7*). It tends to continue rising through the end of the easing phases and even when the Fed starts raising interest rates. Three rate hikes may cause occasional stumbles, but it's hard to see them in the data (*Fig. 8*).

What does stand out is that the tightening phase of monetary policy often ends in tears because it tends to trigger financial crises (*Fig. 9*). Forward P/Es have a tendency to peak before the crises hit as investors begin to fret that higher interest rates may be starting to stress the economy (*Fig. 10*). A lagging indicator of doom is the credit quality yield spread between Baa corporate bonds and US Treasury 10-year bonds (*Fig. 11*). It tends to rise after panic crises hit.

The Fed: Aiming for Real Neutrality. In the prepared remarks for her 3/15 press conference, Fed Chair Yellen said: "We continue to expect that the ongoing strength of the economy will warrant gradual increases in the federal funds rate to achieve and maintain our objectives. That's based on our view that the neutral nominal federal funds rate—that is, the interest rate that is neither expansionary nor contractionary and keeps the economy operating on an even keel—is currently quite low by historical standards. That means that the federal funds rate does not have to rise all that much to get to a neutral policy stance. We also expect the neutral level of the federal funds rate to rise somewhat over time, meaning that additional gradual rate hikes are likely to be appropriate over the next few years to sustain the economic expansion."

On numerous recent occasions, Yellen made the point that policy remains "modestly accommodative." That seems to be true despite the Fed's third 25bps increase in the federal funds rate during the current rate-hiking cycle, which started with similar hikes at yearend 2015 and yearend 2016. Even so, the FOMC won't need to raise rates much further to achieve a neutral stance, rather than an accommodative one, according to Yellen. To understand why, it's first necessary to understand the concept of the real neutral federal funds rate, which Fed officials call "r-star." Consider the following:

(1) *Wishing upon star.* Yellen delved deep into r-star in a 3/3 speech titled: "From Adding Accommodation to Scaling It Back." In it, she succinctly defined "r-star" as "the level of the federal funds rate that, when adjusted for inflation, is neither expansionary nor contractionary when the economy is operating near its potential. In effect, a 'neutral' policy stance is one where monetary policy neither has its foot on the brake nor is pressing down on the accelerator." The economy is on cruise control in this happy state.

The problem is that the Fed is driving blind because there is no way to actually measure r-star. The difference between the actual inflation-adjusted federal funds rate and the educated guestimate of r-star is what might qualify monetary policy as accommodative, neutral, or tight.

The real federal funds rate is simple to calculate. First, take the nominal federal funds rate currently set at a range of 0.75%-1.00%. From it, subtract some measure of inflation. Using the yearly percent change in the core PCED of 1.7%, which is the Fed's preferred measure of inflation, the actual real federal funds rate is somewhere near minus 1.0%.

Recent guesstimates of r-star by Fed officials peg it close to zero. Obviously, r-star by those estimates is above the actual real federal funds rate around minus 1.0%. So now you see why monetary policy can be called "modestly accommodative." By these measures, it would take about four 25bps rate hikes to get policy back to neutral. However, it's not quite that simple because r-star is difficult to measure and its trajectory is uncertain.

(2) *Observer effect*. "Although the concept of the neutral real federal funds rate is exceptionally useful in assessing policy, it is difficult in practical terms to know with precision where that rate stands," Yellen stated in her speech. Back in 2005, the Federal Reserve Bank of San Francisco published an explainer on r-star that is still applicable today. It stated: "The neutral federal funds rate has no explicit value—it is an estimate." Economists "famously disagree on … the range in which the neutral rate falls, and how it might change over time."

In physics, the "observer effect" is the concept that nothing can be observed in its natural state. That's because the observer naturally will have an influence over the subject being observed. In a 6/26/16 blog post from Mises Institute, a research arm of the Austrian school of economics, academician Joseph Salerno wrote: "It is precisely the Fed's attempt 'to set the short-term interest rate *somewhere*' that causes it to be unobservable *anywhere*."

Salerno noted: "If the Fed were to completely halt its manipulation of the money supply, the loanable funds market would not disappear nor would interest rates become indeterminate. The supply of loanable funds would simply shift to the left and the interest rate would rise to a new equilibrium that aligns the loan rate with the long-run rate of return on investment in the real production structure." Maybe so. In any event, monetary policy is complicated because r-star isn't observable. Further complicating matters is that the observing Fed is influencing what is a moving target.

(3) *Shooting star*. Naturally, if the real neutral rate rises faster than expected (as surmised by clairvoyant Fed officials), the FOMC will also have to raise rates faster just to achieve a neutral stance. The FRB-SF's explainer included a quote from a magazine interview with Yellen in which she stated: "The neutral real rate itself depends on a variety of factors—the stance of fiscal policy, the trend of the global economy which shows up in our net exports, the level of housing prices, the equity markets, the slope of the yield curve, or the term premium built into the yield curve. So it changes over time." (For more, see our chronology of how the Fed's thinking about r-star has evolved over recent years in our 10/12/16 *Morning Briefing*.)

For some time, estimates of r-star have been historically low. Have a look at some estimates plotted in Figure 1 of the FRB-SF's 2/21 Economic Letter by the bank's President John Williams. Individual estimates differ, but the range of estimates has moved lower over the past decade. Each estimate is below 1% by Q3-2016. The average of the estimates shown "fluctuated between 2 and 2½% in the 1990s through the mid-2000s, and then plummeted to about ½% around 2009, where it has remained through 2016." Structural factors like the aging population, global savings glut, and declining productivity and innovation might be causing r-star to remain low. Nevertheless, it seems possible to us that forthcoming fiscal stimulus could light a fire under r-star, sending it higher—though there won't be any hard evidence of any of that happening.

(4) *Swan song*. As we discussed yesterday, the median forecast of the FOMC is projecting two more 25bps rate hikes this year to get to a federal funds rate of 1.4% by the end of 2017. Three more hikes are also expected in 2018 to get to 2.1%. Yellen's term as Fed chair expires January 2018. By then, she would like to leave her post with the real federal funds rate closer to neutral, which will end the long period of accommodative monetary policy. Perhaps then she and the markets can get back to normal, whatever that might be.

CALENDARS

US. **Tues:** Current Account Balance -$128.1b. **Wed:** Existing Home Sales 5.555mu, FHFA House Price Index 0.5%, MBA Mortgage Applications, EIA Petroleum Status Report. (Bloomberg estimates)

Global. **Tues:** UK Headline & Core CPI 2.1%/1.7% y/y, Canada Retail Sales 1.3%, Japan Merchandise Trade Balance (yen) 807.2b, BOJ January 30-31 Meeting Minutes, RBA March Meeting Minutes. **Wed:** Japan All Industry Activity Index 0.0%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week to record highs for LargeCap and MidCap. SmallCap's was up for the first time in five weeks to 1.4% below its early February record. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings rose to a 30-month high of 8.3% y/y from 8.2%, which compares to a six-year low of -1.8% in October 2015; MidCap's improved to a 30-month high of 10.6% from 10.4%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's edged down to 12.1% from 12.3%, which compares to a 31-month high of 12.5% in late February and a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax rate changes: LargeCap 10.7% and 12.2%, MidCap 10.1% and 13.3%, and SmallCap 10.7% and 19.0%.

S&P 500/400/600 Forward Valuation (*link*): Valuations mostly rose last week, but remain slightly below recent multi-year highs. P/Es have been melting up recently and beginning to reflect the impact of lower tax rates on corporate earnings, but the 'E' still remains low as analysts await legislative changes to the tax rate. LargeCap's forward P/E was steady w/w at 17.7, down from a 13-year high of 17.8 in early March. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E rose to 18.8 from 18.7; that compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's jumped to 20.0 from 19.6; that's up from a three-year low of 15.5 in February 2016, and compares to a 15-year high of 20.5 in early December when Energy's earnings were depressed and a record high of 20.9 in April 2002. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.92 and MidCap's 1.31 are close to their recent record highs of 1.94 and 1.37, while SmallCap's 1.03 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Q1 earnings estimate revisions were mixed last week for the S&P 500 sectors as analysts continued to make slight adjustments ahead of the upcoming quarterly earnings season. The Q1 consensus rose w/w for two of the 11 S&P 500 sectors, was steady for four, and fell for five. Materials rose 1.8% w/w, and Tech edged 0.1% higher. Sectors with the biggest w/w percentage declines in their Q1 forecasts: Real Estate (-0.9%), Energy (-0.6), and Industrials (-0.3). The S&P 500's Q1-2017 EPS forecast was steady w/w at $29.52, and is down 3.5% from $30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 10.2% y/y, the strongest growth since Q3-2011, with the forecast unchanged from a week earlier and down from 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are higher for 1/11 sectors and lower for 10/11. The Q1 forecast for Real Estate is up 2.7%, and Tech has edged down only 0.3%. Industrials is down the most (-7.5), followed by Materials (-5.1), Consumer Staples (-4.1), Health Care (-3.9), and Consumer Discretionary (-3.2). The S&P 500's Q1-2017 forecasted earnings gain of 10.2% y/y would be its third straight gain after four declines and the highest since Q3-2011. All 11 sectors are expected to record positive y/y earnings growth in Q1-2017, and four are expected to beat the S&P 500's y/y earnings gain of 10.2%. That's an improvement from the 9/11 sectors rising y/y during Q4-2016 and Q3-2016, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. Analysts expect Energy to report a profit relative to a year-ago loss and no longer think Industrials and Telecom will record y/y earnings declines as they had expected at the end of January. The latest forecasted Q1-2017 earnings growth rates vs. their blended Q4-2016 growth rates: Energy (returning to a profit in Q1 from a year-ago loss vs. 5.3% in Q4), Financials (15.9% vs. 11.3%), Tech (14.3, 12.4), Materials (11.5, 7.1), S&P 500 (10.2, 7.8), Industrials (4.8, -0.9), Health Care (2.6, 7.2), Telecom (2.6, -1.5), Consumer Staples (2.4, 7.2), Real Estate (1.4, 8.7), Utilities (1.3, 10.1), and Consumer Discretionary (1.3, 5.2).

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